HOGAN & HARTSON
L.L.P.

COLUMBIA SQUARE
555 THIRTEENTH STREET NW
WASHINGTON DC 20004-1109
(202) 637-5600

BRUSSELS
LONDON
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BETHESDA, MD
DENVER, CO
McLEAN, VA

ROBERT CORN-REVERE
PARTNER
DIRECT DIAL (202) 637-5640

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JUN 16 1994

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

June 16, 1994

BY HAND DELIVERY

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Re: MM Docket Nos. 92-266, 93-215; CS Docket No. 94-28

Dear Mr. Caton:

Pursuant to Section 1.429(h) of the Commission's Rules, the Arts & Entertainment Network and ESPN, Inc., by their attorneys, hereby submit an original and 11 copies of Comments in support of Petitions for Reconsideration filed in the above-captioned proceedings. An additional copy is included to be stamped as a receipt copy.

Please contact the undersigned if you have any questions with regard to this matter.

Sincerely,

Robert Corn-Revere

Robert Corn-Revere

Enclosure(s)

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Before The

Federal Communications Commission

Washington, D.C.

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OFFICE OF SECRETARY

In the Matter of	)	
	)	
Implementation of Sections of	)	MM Docket Nos. 92-266, 93-215
the Cable Television Consumer	)	CS Docket No. 94-28
Protection and Competition	)	
Act of 1992: Rate Regulation	)	

COMMENTS OF A&E AND ESPN IN
SUPPORT OF PETITIONS FOR RECONSIDERATION

Robert Corn-Revere
Michelle M. Shanahan

HOGAN & HARTSON L.L.P.
Columbia Square
555 Thirteenth Street NW
Washington, DC 20004
(202) 637-5600

Attorneys for The Arts and
Entertainment Network and
ESPN, Inc.

June 16, 1994

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SUMMARY

The Arts and Entertainment Network ("A&E") is an independent cable programming entity that delivers the A&E service to more than 59 million cable households and that plans to launch a new service, The History Channel, in January 1995. ESPN, Inc. ("ESPN") distributes sports programming to over 63 million viewers. It also launched a new service, ESPN2, in October 1993. A&E and ESPN submit these Comments in support of the Petitions for Reconsideration and Comments filed in response to the Commission's March 30, 1994 cable rate regulation orders that urged the Commission to increase the incentives for cable systems to add new programming services and to reduce the impediments to the expansion of service offerings. A&E and ESPN encourage the Commission to implement a solution that recognizes the diversity among cable networks and maximizes the congressional and FCC goal of providing programming to the public.

In order to increase programming diversity, the Commission first must modify the 7.5 percent markup for external costs and upgrades. This markup fails to provide a realistic incentive for the addition of programming services, fails to reflect normal business practices, discriminates against low-cost channels, and ultimately will degrade the profitability of programming services. Instead of the 7.5 percent markup, the Commission should adopt a flat fee incentive for new services or a graduated fee based on the national penetration of the programming service. Whether the Commission adopts a flat fee or graduated fee, however, the incentive should reflect actual market behavior and business practices.

The Commission also should revise its rules to avoid fundamentally redesigning cable service as we know it. The current rules penalize new investment in channel capacity for regulated services, encourage operators to invest only in unregulated services while devaluing basic tiers, and hamper operators' ability to

create high penetration tiers of service, whether regulated or unregulated. The rules discourage cable operators from offering new and innovative services as part of basic service, thus threatening to create a world of information "haves" and "have-nots" and to harm new and existing programming services alike.

The Commission should establish adequate investment incentives for new enhanced basic cable services to minimize tiering disputes. Regulatory impediments to investment in channel capacity for regulated services should be eliminated by (1) limiting actionable complaints to the amount of any cable rate increase implemented after February 28, 1994; (2) permitting operators to pass through programming expenses consistent with business practices and without prior approval from franchising authorities; (3) permitting operators to pass through normal system upgrades as external costs on the same basis as increases in costs for public, educational and governmental channels; and (4) applying any changes in the going forward incentives to all channels launched since the effective date of the rules. Finally, the Commission should ensure that cable operators' tiering decisions are not dictated by the rate regulations, but rather by marketplace forces. In this respect, the Commission must state clearly that its à la carte rules do not undermine the enforceability of tiering agreements between cable operators and program networks.

A&E and ESPN urge the Commission to act expeditiously to increase the incentives for cable operators to add new channels and to improve the diversity of programming available to consumers. Any delay in reversing the current rules' significant disincentives to the addition of new programming services could destroy many new programming services.

Before The

Federal Communications Commission

Washington, D.C.

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OFFICE OF SECRETARY

In the Matter of	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation	))))	MM Docket Nos. 92-266, 93-215 CS Docket No. 94-28

To: The Commission

COMMENTS OF A&E AND ESPN IN SUPPORT OF PETITIONS FOR RECONSIDERATION

The Arts and Entertainment Network ("A&E") and ESPN, Inc. ("ESPN"), by their attorneys and pursuant to Section 1.429 of the Commission's rules, hereby submits comments in support of Petitions for Reconsideration filed in response to the Commission's *Second Order on Reconsideration, Fourth Report and Order, and Fifth Notice of Proposed Rulemaking*, FCC 94-38, MM Docket No. 92-266 (released March 30, 1994) ("*Second Order on Reconsideration*") and the *Report and Order and Further Notice of Proposed Rulemaking*, FCC 94-39, MM Docket No. 93-215, CS Docket No. 94-28 (released March 30, 1994) (the "*Cost-of-Service Order*"). 1/

1/ Petitions for Reconsideration regarding the impact of rate regulations on cable programming services were filed by United Video, Public Interest Petitioners, the Commissioner of Baseball, Viacom International, Inc., and Eternal Word Television Network, Additionally, supporting comments addressing programming issues were filed by Ovation, Inc. and PBS Horizons Cable Network ("Programming Providers"), as well as the Times Mirror Company.

In general, the Petitions and Comments urged the Commission to enhance the incentives for adding programming channels, while reducing regulatory impediments to expanding service offerings. Petitions filed by United Video, Public Interest Petitioners, Viacom International, Eternal Word Television Network, and the Commissioner of Baseball urge the Commission to replace the existing 7.5% markup with a more appropriate incentive, as did the Comments filed by Ovation, Inc., PBS Horizons Cable Network, and Times Mirror Company. Most advocated a fixed fee as an incentive to add new programming services. Several of the Petitions and Comments also urge the Commission to eliminate regulatory impediments to adding programming services. 2/ A&E and ESPN support the overall thrust of these Petitions, and hereby offer further reasons for positive Commission action.

I. BACKGROUND

The Arts and Entertainment Network is a cable programming entity that is neither owned nor controlled by any cable operator. The network currently delivers A&E service to more than 59 million cable households throughout the country via cable, TVRO, MMDS and SMATV distribution systems. This cable programming service features critically-acclaimed entertainment programming, including original biographies, mysteries, dramatic programs and specials. The high-quality original programming offered on this channel has earned A&E more CableAce Awards than any other basic cable network. Currently, more than 80 percent of A&E's prime time schedule consists of original productions. Given the success of A&E and the results of consumer research, A&E is planning to launch another cable programming service, The History Channel ("THC"), in January

2/ *See generally Petition of United Video* at 1-2, 4, 8-10; *Petition of Public Interest Petitioners* at 8-16; *Petition of Commissioner of Baseball* at 1-2; *Comments of Programming Providers* at 8-24; *Comments of Times Mirror Company* at 5-7.

1995. THC will be a unique, high-quality programming service, featuring historical documentaries, movies and miniseries. According to independent research, this is the most eagerly-awaited new programming service among consumers. 3/ A&E originally had planned to offer THC as a substantially advertiser-supported service in order to make it available to cable operators at a low cost.

ESPN is the most widely distributed nonbroadcast programming service in the United States. It is distributed via cable, TVRO, MMDS and SMATV systems to over 63 million viewers, representing some 66 percent of American television households. ESPN televises more than 4,500 live and/or original hours of sports programming each year. Its programming philosophy is to present a wide variety of exclusive, high-quality, innovative and in-depth sports programs including both marquee and narrow-interest sports. ESPN2 is a national sports programming service that emphasizes the entertainment appeal of sports and is designed to reach younger audiences. ESPN2 was launched on October 1, 1993 and now reaches 14 million homes.

The History Channel and ESPN2 are only two of a large number of new programming services seeking a place in the increasingly crowded cable universe. Indeed, the coming year had promised to be a landmark year in the new programming arena, with over 100 new programming services planned for introduction. Such launches are an inherently risky proposition in the highly competitive world of cable programming. However, many cable programmers are finding that the Commission's new rate regulations have created even greater hurdles, forcing them either to postpone or to halt the launch of their new

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3/ The 1994 Beta Research Cable Non-Subscriber Study found that, of the respondents most likely to subscribe to cable, the highest number (47 percent) indicated an interest in The History Channel.

programming services. 4/ A recent industry analysis found that, with respect to new programming services, the rate regulations have thrust "an entire industry into chaos and inaction." As a result, there has been "an almost total stifling of new network launches and additions of incumbent networks to channel lineups" that has been described by industry analysts as a "de facto freeze on adding new services." 5/

Fortunately, the Commission has demonstrated an awareness of this problem; both Chairman Hundt and Commissioner Quello voiced support for reconsideration at the recent NCTA Convention. 6/ In particular, Chairman Hundt said he found "much merit" in the proposals for increasing the incentives to add channels to the basic and enhanced basic tiers of service. However, he added that "not all the proposals are consistent with each other" and suggested that the industry must devise and advocate consensus proposals that will enable the FCC to take quick action. 7/

In searching out industry consensus, it is important for the Commission to realize that the programming community is not monolithic, but contains very different players, each with its own strengths. They include

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4/ *See generally* Carter, *Cable TV Industry Shifts Approach As Growth Slows*, NEW YORK TIMES, May 23, 1994 at A1; *125 Proposed Cable Networks Jostle for New Channel Capacity*, COMMUNICATIONS DAILY, May 18, 1994 at 2. *See also* Higgins, & Granger, *Small Nets, Big Problem?*, MULTICHANNEL NEWS, April 25, 1994, at 1; Stern, *Programmers*, BROADCASTING & CABLE, April 11, 1994, at 51.

5/ Paul Kagan Associates, Inc., *Deregulation A Dark Cloud Over Programmers*, CABLE TV PROGRAMMING, May 23, 1994 at 4; Paul Kagan Associates, Inc., CABLE TV REGULATION, May 31, 1994 at 1.

6/ *See* Chairman Reed E. Hundt, *Speech Before the 43rd Annual Convention and Exposition of the National Cable Television Association*, New Orleans, May 24, 1994; *Statement of Commissioner James H. Quello*, NCTA Convention, New Orleans, May 23, 1994.

7/ Speech of Chairman Reed E. Hundt, *supra*.

vertically-integrated networks, independent networks, networks arising from or assisted by retransmission consent agreements and transaction-driven networks (*e.g.*, home shopping services). Even within these categories, there are established networks as well as new and emerging networks, each of which may have a slightly different perspective on the issues presented.

As noted above, the cable programming market is intensely competitive. Survival in an increasingly crowded marketplace can never be taken for granted. This fact has become even more pressing as rate restrictions lead to reduced investment in basic channel capacity. In this environment, the Commission must be especially cognizant of the fact that its comprehensive rules governing the cable industry weigh differently on different programming services. Vertically-integrated services generally have an advantage in obtaining carriage commitments from their partners and often can rely on operators' deeper pockets to carry them through lean times. 8/ Congress described one advantage of its retransmission consent requirement as providing broadcasters an opportunity to negotiate for increased carriage opportunities -- and this has, in fact, occurred. 9/ With respect to transaction-related channels, the Commission has recognized their

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8/ The Commission has recognized these advantages in its rules governing access to programming services. *See Implementation of Sections 12 and 19 of the Cable Television Consumer Protection and Competition Act of 1992*, 8 FCC Rcd. 3359, 3365-66 (1993). MSOs with affiliated programming services also make reciprocal carriage arrangements with other MSOs and their programming affiliates.

9/ *See* S. Rpt. 102-92, 102d Cong. 2d Sess. 35-36 (1992) ("broadcasters may not seek monetary compensation, but instead negotiate other issues with cable systems, such as . . . the right to program an additional channel on a cable system").

unique financial structure, and has interpreted it rules to accommodate the needs of these networks. 10/

Independent networks, on the other hand, receive none of these advantages. In this context, such networks will prosper only by providing superior programming service and only to the extent the Commission's rules recognize and account for the economic realities of the programming market. Independent networks will be able to compete fairly only if the Commission revises its rules to provide genuine financial incentives, as described below. 11/

A&E and ESPN are in the position of being both established programming services, with approximately 59 million and 61 million subscribers respectively, as well as startup services, with The History Channel and ESPN2. It is vital that the Commission seek to implement a solution that recognizes the diversity among cable networks and that serves to maximize the goal of providing programming to the public. The government should not be in the business of picking "winners" and "losers" among the various players.

It is important to be clear: A&E and ESPN are not asking the Commission to provide them with a regulatory edge over other programming networks. The remedies described in these Comments should be available to all. 12/

10/ *See Letter to QVC Network, Inc. from Alexandra M. Wilson* (released May 9, 1994); *Letter to The Home Shopping Network from Alexandria M. Wilson* (released May 9, 1994).

11/ ESPN2 was conceived and developed as an independent service before the retransmission consent rules existed. While the rules subsequently became part of ESPN2's marketing efforts, the network's continuing growth will be greatly affected by the outcome of this proceeding. ESPN2 shares the problem common to all new programming services -- a shortage of investment in basic and enhanced basic channel capacity.

12/ One exception would be transaction-related channels, which are based on a different economic model than traditional programming services. The Commission has evidently agreed with the providers of such services that "home shopping

Nor are A&E and ESPN asking the Commission to reduce the regulatory advantages available to other networks. They simply are asking the FCC to understand that adequate financial incentives are essential to the survival and growth of all programming services.

II. THE COMMISSION MUST INCREASE BASIC CABLE PROGRAMMING INCENTIVES IN ORDER TO FULFILL THE CONGRESSIONAL GOAL OF ENHANCING PROGRAMMING DIVERSITY

The interest in increasing diversity of programming pervades the Commission's mass media regulations in general, and the 1992 Cable Act in particular. 13/ Congress emphasized the goal of expanding program diversity throughout the Conference and Committee Reports accompanying the 1992 Cable Act as well. 14/ The Commission certainly recognized this interest when it adopted the rate regulations. The Commission stated that "a goal of our 'going-forward' methodology is to allow cable operators to grow and develop new facilities and

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channels are not program services but [are] a new form of retailing" that rely on compensation arrangements unlike those of more traditional cable networks. *See Letter to QVC Networks, Inc. from Alexandra M. Wilson* (released May 9, 1994). Accordingly, the incentive structure described herein would not be necessary or appropriate for home shopping services.

13/ *See FCC v. National Citizens Comm. for Broadcasting*, 436 U.S. 775, 780 (1977) ("the Commission has long acted on the theory that diversification of mass media ownership serves the public interest by promoting diversity of program and service viewpoints"); *Associated Press v. United States*, 326 U.S. 1, 20 (1945) (describing the First Amendment goal of achieving "the widest possible dissemination of information from diverse and antagonistic sources"). *See also* 1992 Cable Act, Pub. L. No. 102-385, § 2(a)(6), 106 Stat. 1460, 1461; H.R. Conf. Rep. No. 862, 102d Cong., 2d Sess. 49, 53, 56 (1992); S. Rep. No. 92, 102d Cong., 2d Sess 69 (1992); H.R. Rep. No. 628, 102d Cong., 2d Sess. 77 (1992).

14/ *See, e.g.*, H.R. Conf. Rep. No. 862, 102d Cong., 2d Sess. 49, 51 (1992); S. Rep. No. 92, 102d Cong., 2d Sess. 70 (1992); H.R. Rep. No. 628, 102d Cong., 2d Sess. 77 (1992).

services, including new and innovative regulated programming services." 15/ But the Commission's rate regulations sacrifice diversity by failing to provide adequate incentives to add or maintain cable programming services on regulated tiers. In order to carry out congressional intent, serve the public interest, and satisfy its own stated goals, the Commission must revise its rules to establish the appropriate incentives.

A. The Commission Must Modify The 7.5 Percent Markup To Provide Incentives For The Addition Of New Programming Services

The Petitions and Comments filed with the Commission argue that the percentage markup for external costs and upgrades must be greater than 7.5 percent. A&E and ESPN agree. Given the low per subscriber price of most cable services, a 7.5 percent markup provides no realistic incentive to add services, fails to reflect normal business practices and ultimately will degrade the profitability of programming services.

It also is important to acknowledge that a markup based exclusively on a percentage of per-subscriber prices discriminates against low-cost channels in favor of high-cost channels. Such a markup will encourage operators to add the most expensive channels they can find in order to maximize their return. For example, an operator which adds to a regulated tier a channel that costs $3.00 per month will receive a markup of 22.5 cents, while an operator which added a channel that costs 10 cents per subscriber per month would receive a markup of less than a penny. Another perverse effect of a percentage-based scheme is that it may encourage programming services to charge more (to the extent they can do so in a competitive programming market) and thereby drive up prices generally.

15/ *Second Order on Reconsideration* at ¶ 238 (emphasis added).

B. The Commission Should Adopt a Flat Fee Incentive

The Commission should consider an alternative method of providing programming incentives that would not be tied to a percentage of the licensing fee. The Commission could specify a certain amount (*e.g.*, 30 cents) that an operator could charge for new channels on regulated service tiers, in addition to the amount of the licensing fee. Such an approach could be formulated to take into account the risk associated with launching new services.

As a possible variation on this plan, a flat fee markup could be graduated based on national penetration of the service (*e.g.*, the permitted charge for a new channel with 20 million subscribers or less would be the licensing fee plus 30 cents; the charge for a service with 20 to 30 million subscribers would be the licensing fee plus 25 cents; and the charge for a service with more than 30 million subscribers would be the licensing fee plus 20 cents). Where a given programming service fits on this scale could be adjusted periodically, perhaps every two years. 16/ There would be several advantages to this type of incentive plan. A specified markup figure should be easier to apply than a percentage rate, and it would not favor more expensive channels. Thus, operators would be freed to make channel choices based on their independent assessment of programming quality, not price. Adjusting the size of the incentive based on nationwide penetration simply recognizes the economic reality that services with higher penetration rates are less dependent on subscriber fees and can gain more revenue from advertising. Such an

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16/ Periodic adjustments should be applied prospectively and should not operate to reduce the markup allowed for systems that initially sign up for an emerging programming service. The higher markup would serve to reward operators which accept the risk of adding a new service.

approach should nurture new programming services and ultimately would be better for subscribers. 17/

One of the central questions facing the Commission is the selection of an appropriate number for the markup. The proposal contained in these Comments is intended to meet three goals: (1) to provide adequate incentives for the addition of new programming services taking into account business realities; (2) to ensure reasonable rates consistent with the demands of the Cable Act; and (3) to ensure ease of administration. As explained in more detail below, this proposal should provide greater incentives for new services because it more closely approximates the relationship between product cost and the retail price of cable service. The 20-30 cent markup proposed herein is an extrapolation based on the typical relationship between programming costs and tier prices. Its "reasonableness" under the Cable Act is supported by the FCC's rate survey data and by comparison with other rate regulation regimes. Finally, a specified fee should be far easier to administer than a "customized" calculation that would be different for each new service.

17/ If the Commission believes it is necessary, it might consider capping the amount of a basic rate increase allowable in a given year (*e.g.*, $2.00 or a percentage of the total tier price) in order to preclude possible "sticker shock" for cable subscribers. The Commission must take care, however, to avoid stifling the addition of new networks. For example, the entire "cap" amount could be met by the downward migration of one "mini-pay" channel to a regulated tier -- a decision that would not increase diversity and would possibly raise negative option questions. The Commission should avoid creating an economic incentive for such an outcome. Also, to the extent possible, the Commission should avoid adopting a rate "cap" that acts effectively as a service cap. Accordingly, the Commission should consider making other rule changes that would permit operators to add services without sacrificing the ability to recover costs over time. For example, the Commission should eliminate the rule that "[a] system that does not adjust its permitted rates annually to account for [external cost] changes will not be permitted to increase its rates subsequently to reflect the changes." 47 C.F.R. § 76.922(d)(3)(i).

Any modification of the current 7.5 percent markup approach must reflect the economic realities of the programming market in order to provide cable operators with a realistic incentive to add new programming services. In this regard, it would be a mistake for the Commission to seek a precise mathematical formulation of what is an adequate incentive or to treat the going forward rules as a "mini cost-of-service proceeding." Instead, the Commission should examine real-world market behavior in the context of its mandate to ensure that rates are reasonable. Within this framework, more than one of the specific proposals advocated by various programming services may fall within a zone of reasonableness. 18/ However, any approach that deviates too far from established market conditions is likely to provide inadequate incentives.

The relationship between programming costs and tier prices in a typical cable system provides an appropriate touchstone for calculating the markup. That is, the Commission can determine generally the amount of a markup operators need to cover costs including salaries, overhead, marketing, etc. by comparing the ratio of licensing and copyright fees ("product cost") and the total tier price. Based on the experience of A&E and ESPN in the cable marketplace, it is our belief that product cost constitutes approximately 12 to 15 percent of the retail price for a typical medium-sized cable system's regulated tier. In other words, the amount of the markup must be greater than the amount of the licensing and copyright fee (in most cases) if the Commission's rules are to approximate market incentives. 19/

18/ For example, various parties are advocating a 25-cent flat fee incentive. Such an approach is consistent with the proposal described herein, and certainly falls within a zone of reasonableness.

19/ Operators would be permitted to take a more substantial markup than proposed herein if the Commission strictly adhered to a calculation of the product cost ratio. However, this proposal was formulated conservatively in order to balance real world economic considerations with the demands of rate regulation.

This estimate can be verified by reference to publicly available sources. For purposes of illustration, A&E and ESPN investigated the price of a hypothetical enhanced basic tier composed of the 20 most popular satellite-delivered services. 20/ Assuming a $20 tier price, the product cost ratio would be approximately 15 percent. 21/

The reasonableness of using a product cost ratio as a basis for establishing programming incentives is further supported by comparing the results to per-channel prices established under rate regulation. Using the hypothetical tier described above, the average licensing fee, as adjusted, would fall in the range of 14 to 16 cents per subscriber per month. Adding a 30 cent markup would result in a per channel price of approximately 45 cents, an amount that is consistent with per-channel prices established pursuant to the Commission's rate survey. 22/ It also is noteworthy that under Canada's strictly regulated cable television system, the CRTC recently approved a $3.00 price for a package of six new English language "expanded basic" networks, or 50 cents per channel. 23/

20/ This hypothetical tier would contain the following channels: ESPN, CNN, USA, Discovery, TBS, TNT, C-SPAN, Nickelodeon, The Family Channel, The Nashville Network, Lifetime, A&E, MTV, The Weather Channel, Headline News, CNBC, VH-1, American Movie Classics, Black Entertainment Television and WGN.

21/ The product cost of the hypothetical tier would fall in a range from approximately $2.83 to $3.20. The estimates are based on top of the rate card projections for 1993 and 1994. These figures were adjusted downward by 30 percent to account for MSO discounts and staggered renewals of affiliation agreements. *See, e.g.*, Paul Kagan, Inc., CABLE TV PROGRAMMING, April 30, 1994 at 2-3; Paul Kagan, Inc., CABLE TV PROGRAMMING, May 23, 1994 at 6. This hypothetical may overstate the ratio somewhat to the extent operators include less popular or lower priced services in their tiers.

22/ Paul Kagan, Inc., CABLE TV PROGRAMMING, April 30, 1994 at 2-3.

23/ *Canadian Govt. Okays Launch of 10 New Cable Channels*, COMMUNICATIONS DAILY, June 8, 1994 at 2.

The proposed method of establishing the amount of a markup would more accurately reflect realistic business practices and provide a stronger incentive for cable operators to add new channels to their line-ups. It also provides a check on the reasonableness of price increases that is consistent with the Cable Act, and should be easy to administer. Whatever proposal the Commission adopts, however, it must replace the current 7.5 percent incentive scheme.

C. External Cost Markups Should Be Calculated to Avoid Churn

The Commission should take care that its going forward methodology does not create an incentive to add or delete programming services based on the rules' economics rather than sound editorial practices. If the amount of the markup allowed for cost increases for existing services leads to a declining margin over time, operators will have an incentive to drop existing services for no other reason than to preserve existing margins. Comments filed with the Commission note that with such a markup, "the operator's margin may be progressively reduced" and "[a] 7.5% return on additional programming investments will not, under current economic conditions, be sufficient to warrant such investments." 24/ Indeed, a 7.5 percent markup will fail to even cover the cost of borrowing money necessary to cover higher costs. The Commission should adjust the amount of the markup to reflect this concern. Consequently, to help prevent margins from eroding, the Commission should increase the markup amount for existing channels from 7.5 to 15 percent.

24/ Cox Cable Communications, Inc. and Newhouse Broadcasting Co., *Adding Channels: A Proposed Approach for Restoring Incentives To Carry New Programming Services*, (May 31, 1994) at 18.

III. THE COMMISSION SHOULD ACT TO MINIMIZE DISPUTES OVER SCARCE "SHELF SPACE" ON REGULATED TIERS

A. Rate Regulations Threaten to Alter Fundamentally the Nature of Cable Television Service Offerings

Cable service has grown over the years through the offering of broad and diverse basic and "enhanced" basic tiers of programming services. Within this framework, cable service is most valuable to consumers because of the strength of the "team" assembled in these basic packages. Putting these packages together is fundamentally an editorial decision on the part of cable operators, and it has served consumers well. The Cable Act endorsed the concept of individual choice through per channel or a la carte offerings. But this does not mean that the Commission was directed or empowered to undermine the value of basic tier offerings or to advocate the migration of established services to unregulated tiers. The Cable Act directed the Commission to ensure that rates are reasonable -- not to fundamentally redesign cable service as we know it. 25/

Unfortunately, the Commission's current interpretations of its rate regulations threaten to do just that. The current rules penalize new investment in channel capacity for regulated services, encourage operators to invest only in unregulated services while devaluing basic tiers, and hamper operators' ability to

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25/ A&E and ESPN previously raised a number of these points with the Commission. *See Comments of Arts and Entertainment Network*, MM Docket No. 92-266 (filed January 27, 1993 at 9 ("the FCC should concern itself with implementing a rate regulation model that will ensure that subscribers pay marketplace or quasi-marketplace rates, and avoid a regulatory system that discourages or effectively precludes cable operators from offering additional services as part of the basic tier"); *Comments of ESPN, Inc.*, MM Docket No. 92-266 (filed January 27, 1993).

create high penetration tiers of service, whether regulated or unregulated. 26/ The net effect will be to incent operators to place new and innovative services on tiers further removed from their basic customers, and risks creating a world of information "haves" and "have-nots." 27/

Such tiering decisions can make or break both old and new networks. Established services depend on existing penetration levels in order to maintain advertising revenues, while new services are seeking ways to be grouped with existing services for the same reason to maximize penetration. Both types of networks will suffer to the extent the Commission's rules tend to limit the amount of shelf space for basic and enhanced basic services. For example, Paul Kagan Associates has estimated that a 10 percent drop in penetration for a well-established network would lead to a reduction in cash flow by two-thirds; a 25 percent drop in audience reach "could theoretically wipe out cash flow." 28/ Because "[t]he average network spends virtually 100% [of] network ad revenue on programming . . . especially [on] costly original productions," even a small reduction in penetration would force an established network to slash new programming outlays. The result, according to the Kagan study, would be "a damaging chain reaction" that "could negatively affect program budgets, resulting in

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26/ *See Petition of Public Interest Petitioners* at 10 ("To the extent that this policy can be characterized as an effort to choke off investment in basic cable channels, it certainly appears to have been a success.").

27/ *See, e.g.*, Farhi, *FCC Chairman Seeks to Reassure Cable TV Industry*, WASHINGTON POST, May 25, 1994 at F3 ("If the regulations aren't changed," said John Hendricks, President of the Discovery Channel, "new services will only be available to the affluent.").

28/ Paul Kagan Associates, Inc., CABLE TV PROGRAMMING, March 23, 1993 at pp. 1-2.

homogenization of cable programming and fewer choices for the cable consumer." 29/

Similarly, new networks will have a difficult time getting started without access to high-penetration tiers. A recent report by Saatchi & Saatchi found that "many of the proposed startup networks will find the growing rough" because "channel capacity is tighter than ever" and cable operators are not being encouraged to add to basic channel capacity. 30/ A&E and ESPN well understand this dilemma, given their position as two of the most well-established advertiser-supported networks as well as their status as emerging networks with ESPN2 and The History Channel. The Commission must seek to solve the problems of both new and existing networks. 31/

Much of the discussion on this issue has centered on the Commission's rules regarding à la carte packaging. Certainly the rules should be clarified in a way that is fair. But the Commission should not assume that any such clarification solves the underlying problem of scarce channel capacity. The only way to effectively minimize tiering disputes is to provide adequate investment incentives.

B. The Commission Must Encourage Investment in Regulated Services

The à la carte dilemma exists primarily because the rules deter investment in and expansion of existing regulated tiers. Unfortunately, the rules are expressly oriented toward promoting new investment in unregulated services.

29/ *Id.* (abbreviations omitted).

30/ Erica Gruen, CABLE TELEVISION 1993-94 at 2, 6 (Saatchi & Saatchi 1994) ("Especially vulnerable will be the small and medium-sized networks with 10-30 million subscribers."), attached as Exhibit 1 to *Comments of Programming Providers*, MM Docket No. 92-266 (filed May 16, 1994).

31/ *See, e.g.*, *Comments of Programming Providers*, at 19-22.

To the extent this is true, the services available on basic or enhanced basic tiers will continue to decline, while the number of unregulated services will increase.

Despite the need for increased capacity for basic and enhanced basic services, the Commission's rules clearly promote investment in unregulated services. "Throughout th[e Commission's] Order," decisions relating to "growth in programming services, channel additions and deletions, and system upgrades" are based on the economic principle of holding down basic rates. *Second Order on Reconsideration*. ¶¶ 54, 57. Put another way, the Commission was willing to accept reduced investment in basic cable services on the theory that cable operators would then invest in new and unregulated services. For example, the FCC frankly acknowledged that "investment could initially be adversely affected by reductions in the cash flows generated by current regulated services." *Id.* at ¶ 59. *See also id.* at ¶ 61. It concluded that any lost investment would be only a short term effect because "many operators will have opportunities to generate steadily increasing cash flows from *unregulated* services." *Id.* (emphasis added).

The only apparent recognition of the need for new investment in basic capacity came in the *Cost of Service Order*, at ¶¶ 295-304, in which the Commission adopted an experimental "Upgrade Incentive Plan." Under this plan, an operator may enter into "a social contract with its customers" under which it agrees to freeze existing rates and services for a period of years in exchange for "substantial flexibility in setting rates for new regulated services it introduces." 32/ *Id.* at ¶ 296.

32/ *Cost of Service Order* at ¶ 296. It is unclear from the *Order* that the operator would be permitted to pass through programming cost increases. *See id.* ("customers would be guaranteed that rates for current services would be kept stable and reasonable, no higher than rates before the contract takes effect or the benchmark/price cap rate (which *might* include adjustments for inflation and external cost changes)") (emphasis added). The contract would extend for a term of years and would be overseen by the Commission. *Id.*

The Commission must approve any such offering of service in advance. These experimental plans would also be monitored by the Commission, and reviewed no later than their fifth year of operation. *Id.* at ¶ 303.

So far, according to the Commission staff, no operators have stepped forward to take advantage of the Upgrade Incentive Plan. 33/ And it is extremely unlikely that any operator will do so. First, in order to obtain "substantial flexibility" in offering new regulated tiers, the operator must submit to enhanced oversight by both the FCC and local authorities. 34/ The Commission must approve the plan, monitor its progress and evaluate its merits after five years. It is unrealistic for any operator to submit to this level of governmental involvement in its business when greater pricing flexibility is readily obtainable simply by adding unregulated services. Second, the Upgrade Incentive Program is an "experimental" program and thus provides no basis for long-term investment. Third, no dynamic industry would willingly submit to a freeze on its service offerings, particularly when faced with the prospect of competition from DBS and other entities. Such a government-imposed straitjacket would render the industry ill-equipped to compete with the flexible service offerings of competitors.

The Commission can resolve the dilemma facing program networks by encouraging investment in new enhanced basic services. Creating realistic incentives for such services, as detailed above, would help in this regard. The Commission also should eliminate impediments to investing in channel capacity for

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33/ This information was revealed during the FCC staff panel at the NCTA Convention.

34/ The views of local franchising authorities regarding any agreement are solicited as part of the approval process even though any new regulated tier would be outside the jurisdiction of local authorities. *Cost of Service Order* at ¶ 304.

regulated services. It could do so expeditiously by granting certain of the Petitions for Reconsideration now pending. In particular, the Commission should:

1. Limit the scope of actionable complaints to the amount of any rate increase implemented by cable operators after February 28, 1994. The Commission's current interpretation, in which a new complaint subjects an operator's entire rate structure to review, is contrary to law and precludes the addition of new services. 35/

2. The Commission should permit operators to pass through programming expenses in a manner that is consistent with current business practice, and should not require prior approval of pass-throughs by local franchising authorities. 36/

3. The Commission should permit normal system upgrades to be passed through as external costs on the same basis as increases in costs for public, educational and governmental channels. 37/

4. The Commission also should apply any changes in its going forward incentives to all networks launched since the effective date of the rules.

C. FCC Rules Should Not Dictate Tiering Decisions

The Commission's decision regarding à la carte packages undoubtedly will have some effect on existing tier structures. But whatever policy the Commission ultimately adopts, it must strongly affirm the principle that tiering decisions should not be dictated by the rate regulations. As a fundamental matter, the Commission must make clear that nothing in its rules would abrogate existing

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35/ *See United Video Petition* at 9; *Programming Providers Comments* at 13-16; *Public Interest Petition* at 12-13, 15.

36/ *United Video Petition* at 2-4; *Programming Providers Comments* at 17-19.

37/ *Public Interest Petitioners* at 15. *See also* Public Notice, *Questions and Answers on Cable Television Rate Regulation*, Mimeo No. 42927 (May 6, 1994) (Question 12).

contracts between programmers and operators, including provisions that prevent à la carte offerings of a network.

It is axiomatic that some programming services are appropriate to be offered as a per-channel or à la carte service, while others are not. For example, Turner Classic Movies reportedly is projecting profitability once it reaches just over three million subscribers. 38/ Similarly, the Golf Channel is being positioned as an à la carte service, which will achieve profitability after it reaches two million subscribers. 39/ Either of these services would be appropriate as "anchor tenants" for an à la carte tier. Certain established networks also may contractually agree to such tier placement. Others, however, like ESPN and A&E, do not consider à la carte packaging an acceptable marketing strategy, and have made this position clear in affiliation agreements. Specifically, certain program licensing agreements between producers and the networks may require carriage on regulated tiers. The government should not intrude into these relationships.

These editorial decisions, are best made by the marketplace, not by bureaucratic rule. Cable operators and program networks negotiate tiering issues and enforce them contractually. The Commission has endorsed such an approach to channel placement as part of its retransmission consent rules. 40/ Accordingly, the Commission should state clearly that its à la carte rules do not affect existing affiliation agreements governing tiering, and that nothing in the FCC's orders

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38/ Paul Kagan Associates, Inc., *TCM: $1 Billion Asset By Decades End?* CABLE TV PROGRAMMING, April 30, 1994 at 4.

39/ Paul Kagan Associates, Inc., *Out of the Sand Trap: The Golf Channel Lands $60 Million in MSO Green*, CABLE TV PROGRAMMING, May 23, 1994 at 6.

40/ *See Implementation of the Cable Television Consumer Protection and Competition Rules, Notice of Proposed Rulemaking*, 7 FCC Rcd. 8055, 8067 (1993).